



MEMORANDUM

May 21, 2009

To: Honorable Gregory Meeks
Attention: Tre Riddle

From: Baird Webel, Specialist in Financial Economics, x7-0652
Rena Miller, Analyst in Financial Economics, x7-0826

Subject: **Proposed Legislation on Securities and Exchange Commission Rule 151A**

This memorandum responds to your request for an evaluation, particularly focusing on the “pros and cons,” of draft legislation entitled the “Fixed Indexed Annuities & Insurance Products Classification Act of 2009.” The memorandum begins with a brief summary of Securities and Exchange Commission (SEC) action on the issue and of the bill as drafted. Following this is a discussion of annuity products, their regulation, and the specific impact of SEC regulation of indexed annuities as called for in SEC Rule 151A. Portions of this memorandum are based on other CRS products, and portions may appear in future CRS products available to other Congressional offices. For more information on annuities in general and SEC Rule 151A in particular, see CRS Report R40008, *Converting Retirement Savings into Income: Annuities and Periodic Withdrawals*, by Janemarie Mulvey and Patrick Purcell and CRS Report RS22974, *Annuities and the Securities and Exchange Commission Rule 151A*, by Baird Webel. Please call us if we can be of further assistance.

SEC Promulgation of Rule 151A

As insurance products, all annuities are regulated at the state level. Some annuity products, however, are also considered securities products and regulated by the SEC. On June 26, 2008, the SEC announced a proposed rule regarding indexed annuities.¹ This rule was finalized on January 8, 2009.² Specifically, Rule 151A removed an annuity contract from the insurance exemption in the Securities Act of 1933 if “the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.”³ The same proposal also added Rule 12h-7, exempting state-regulated insurance companies from the requirements under the Securities Exchange Act of 1934 to file reports on such annuity contracts. The effective date of the rule is to be January 12, 2011. The primary impact of this rule change is that many, if not most, of the practices of those companies and individuals selling

¹ The products in question are referred to by a variety of different terms including “equity indexed annuities,” “fixed indexed annuities,” and simply “indexed annuities.” This memo will use the term “indexed annuities.”

² See the SEC website “SEC Final Rules” at <http://www.sec.gov/rules/final.shtml>.

³ U.S. Securities and Exchange Commission, “Indexed Annuities and Certain Other Insurance Contracts,” 73 *Federal Register* 37752, July 1, 2008.

indexed annuities will be regulated by both the SEC and the states. This rule was controversial, with several thousand comments to the SEC opposing it, including several written by Members of Congress.

The Proposed Fixed Indexed Annuities & Insurance Products Classification Act of 2009

This bill would amend the Securities Act of 1933 to specify that this act's exemption from the definition of a securities product would include "any insurance or endowment policy or annuity contract or optional annuity contract (A) the value of which does not vary according to the performance of a separate account, and (B) which satisfies standard nonforfeiture laws or similar requirements." The bill would also specifically annul Rule 151A as promulgated by the SEC.

This bill would have the effect of returning the regulation of indexed annuities to the status quo before the SEC's promulgation of Rule 151A, namely, indexed annuities would be exempted from SEC regulation and solely subject to regulation by the state insurance regulators.

Evaluating the pros and cons of the draft bill revolves around two questions. First, are there significant consumer protection problems regarding indexed annuities? Second, if there are problems, is SEC regulation an effective or efficient way to address these problems? This memo will provide information and arguments that have been made addressing these issues.

Annuities and Fixed Index Annuities

Annuities are a wide ranging financial product. Some are relatively simple products designed to pay a set amount per month; some are complex products that may base payments on a variety of other investments combined with different forms of financial guarantees.

Indexed annuities are a relatively recent invention combining elements of fixed annuities, which offer returns based on a fixed interest rate, and variable annuities, which offer returns through investment holdings chosen by the annuitant. Indexed annuities have tended to be complex products with features that sometimes may be difficult to value. Specifically, a common indexed annuity offers an investment return based on the level of a specific securities index combined with a guaranteed minimum return should the securities market fall. Unlike variable annuities in which the actual securities investments are held in segregated accounts, indexed annuities credit the annuity holder with a return based on a securities index, but the actual securities may or may not be held by the insurance company. The indexed annuity investment return typically does not include dividends that would have accrued had this amount been actually invested in the particular securities index. In addition, there are often insurance options, such as some death benefit upon the death of the annuitant, or a survivor benefit to base payment on the death of the second person in a couple rather than on one person. The various options available in indexed annuities, or other annuities, are often paid for through charges based on a percentage of the account value. There are also typically significant surrender charges should a purchaser wish to cancel the annuity contract early.

Annuities in general have been somewhat controversial, with opinions varying widely as to their suitability for many investors. Complaints about annuities include high fees on the investment funds, a lack of liquidity due to high surrender charges, and deceptive sales practices, particularly with regard to sales to senior citizens. These complaints, it should be noted, are not limited to indexed annuities, but include the variable annuity products that have been regarded as securities products under SEC regulation

for decades. Defenders of annuity products point out that annuities can play an important role in retirement planning. They offer tax-deferred growth for investments and are the only product that can offer a lifetime guaranteed income.

Consumer Protection and Annuities

Both state and federal regulators have concluded that annuities in general present consumer protection issues and need particular regulatory attention. In proposing Rule 151A, the SEC cited the need to protect investors, particularly older investors, from fraudulent and abusive practices related to the sale of indexed annuities. Annuity sales practices have drawn complaints from consumers and various regulatory actions from state regulators and the SEC/FINRA over many years. The complexity of annuity products can allow unscrupulous sellers to take advantage of less-sophisticated buyers, while high commissions on some annuities may give sellers a substantial financial incentive to sell these products. The alleged sales abuses seem to particularly concern older consumers. For example, a joint “Investor Alert” by the SEC, FINRA, and the North American Securities Administrators Association (NASAA) cites variable annuities as one of a number of products that are commonly used to defraud senior citizens.⁴

State regulators have also taken particular actions to protect consumers from abuses in annuity products. To help guide states in their oversight efforts, the National Association of Insurance Commissioners (NAIC) has developed language for “model laws and regulations” to provide guidelines for legislators to modify and adopt in their respective states. These models have included an “Annuities Disclosure Model Regulation” and a “Suitability in Annuity Transactions Model Regulation.” The NAIC Model Suitability language requires insurance companies to give objective financial information to potential purchasers, and it requires agents to use a standardized form to determine whether an annuity would be suitable for the potential purchaser. Some state laws ban the use of professional designations or titles – such as Senior Financial Advisor – that might mislead senior consumers into thinking that the advisor has special financial expertise related to the needs of older consumers.

The NAIC Annuity Disclosure Model Regulation requires certain information to be disclosed, including information about premiums and how they are charged, a summary of the options and restrictions for accessing money, and an outline of fees. NAIC models, however, must be adopted by the individual states before they can take effect. According to the NAIC, 33 states have enacted the NAIC model on annuity suitability and 22 have enacted the model on annuity disclosure. In addition to the model laws and regulations, the NAIC addressed perceived abuses in annuity marketing with a “Buyer’s Guide” for prospective purchasers of annuities. This guide includes a specific section on indexed annuities.

What SEC Regulation Would Entail

In order to meet the requirements of SEC Rule 151A, companies offering indexed annuities will have to file registration statements with the SEC, prepare and distribute prospectuses to prospective purchasers, and comply with the anti-fraud provisions of the federal securities laws, such as Section 10(b) of the Securities Exchange Act of 1934 (“the 1934 Act”). Becoming subject to the anti-fraud provisions of the federal securities laws means, among other things, that companies selling indexed annuities could be subject to liability – either via private lawsuits from purchasers of the annuities, or civil liability through the SEC’s enforcement powers – under the Securities Act of 1933 for any material misstatements or

⁴ “Investment Products and Sales Practices Commonly Used to Defraud Seniors: Stories from the Front Line,” available on SEC’s website at <http://www.sec.gov/spotlight/seniors/elderfraud.pdf>.

omissions in the prospectuses they distribute to purchasers. The registration statements that insurance companies offering these products will have to file with the SEC must include a description of the securities to be offered for sale; information about the management of the issuer; information about the securities; and financial statements certified by independent accountants.

In addition, under the new SEC rule, individual sellers of registered indexed annuities will be required to be registered broker-dealers, and will become subject to oversight by the Financial Industry Regulatory Authority (FINRA). Alternately, sellers of indexed annuities could become associated persons of an established broker-dealer through a networking arrangement. This provision will likely entail new compliance requirements for some firms selling indexed annuities, although it will offer some additional protection to buyers. Broker-dealers selling indexed annuities after Rule 151A's effective date of January 12, 2011, for instance, will fall under an obligation to make only suitable recommendations for the prospective buyer, and to comply with specific books and records, supervisory and compliance requirements under the federal securities laws. This may arguably result in greater standardization of selling practices, which are currently subject to individual state oversight.

It is worth noting that under the terms of Rule 151A's companion rule 12h-7, companies would be exempt from the regular reporting requirements to the SEC mandated by the 1934 Securities Exchange Act, which many other registered companies face, as long as the issuer of indexed annuities is already subject to state insurance regulation. The issuer must also file annual statements of its financial condition with its state regulator to qualify for this reporting exemption. Finally, to be exempt from reporting requirements, the insurance company selling the indexed annuities must also take steps to ensure that a secondary trading market for its indexed annuities does not emerge, since the provisions of the 1934 Act are aimed at issues surrounding the trading of securities.

Thus, while bringing companies offering indexed annuities under federal regulation, the SEC has at the same time chosen not to require additional regulatory updates such as the quarterly 10-Q and annual 10-K filings which other registered companies must submit to the SEC. The reasoning for this, according to the SEC in its final rule, is that, though the indexed annuities will be considered securities under the new rule, they will not be traded in a secondary market, and activities of the insurance companies issuing them, including the seller's assets and income, are already monitored and regulated at the state level. The SEC argues that this exemption from reporting requirements will lessen the burden and costs on the industry of implementing Rule 151A. However, critics of the rule have responded that the SEC has underestimated the costs and burden of implementing Rule 151A, and that the SEC has overstepped its statutory authority in attempting to regulate this product.⁵

Scope of Rule 151A

Only indexed annuities issued on or after the effective date of the rule—January 12, 2011—will need to register with the SEC and distribute prospectuses. Those issued and existing prior to January 12, 2011, would not be affected by the SEC's Rule 151A. One focus of critics' arguments has thus been on any potential future dampening effect on prospective competition or the offering of new indexed annuities products after that date.

⁵ See Opening Remarks and Dissent of SEC Commissioner Troy A. Paredes Regarding Final Rule 151A: Indexed Annuities and Certain Other Insurance Contracts, at the Open Meeting of the Securities & Exchange Commission, December 17, 2008 in U.S. Securities and Exchange Commission, "Indexed Annuities and Certain Other Insurance Contracts; Final Rule," *74 Federal Register* 3175, January 16, 2009.

The SEC Rule 151A would not automatically apply to all indexed annuities. Instead, indexed annuities will only be considered securities and thus be forced to register with the SEC if the expected payout of the annuity is more likely than not to exceed the minimum guaranteed amount under the annuity contract. The SEC considers the payout to be more likely than not in excess of the minimum if this were the expected outcome more than half the time. However, it is up to the seller of the indexed annuities to analyze the expected outcomes under various scenarios, and to make that determination. Arguably, a buyer of annuities might infer that an unregistered annuity would fail that outcomes test—although some believe this would depend upon the sophistication of the prospective buyer.

Cost of SEC Regulation

In its proposed rulemaking, the SEC offered a cost estimate of complying with the rule. This drew a number of comments, particularly from industry groups, arguing that the costs of implementing the registration requirement would be higher than the SEC estimate.

The SEC estimated that the total cost savings to insurance companies that will be spared having to file regular quarterly and annual reports would be \$15,414,600, based on the number of filings it receives from insurance companies, a total of 49,994 burden hours for preparing the reports, and an hourly rate of \$175 for the work of preparation by in-house staff, with 16,664 hours at \$400 per hour for the work of preparation by outside professionals.⁶ The SEC then estimated the total cost of preparing the new registration statements by companies at \$82,500,000, based on 60,000 burden hours estimated of in-house work at \$175 per hour and an additional \$72,000,000 cost estimate for outside professionals' work.

Several commentators disagreed with the SEC's cost estimates. Some stated that consumers would face added costs, because the costs of preparing prospectuses and registering as broker-dealers would be passed along to the consumer; and others stated the new rule would place a disproportionate burden on small insurance distributors. Others wrote that the hourly rates used by the SEC in its estimations were too low.⁷

Pros and Cons of the Proposed Legislation

SEC's Rule 151A establishes federal regulation for companies and individuals selling indexed annuity products while the draft legislation would annul this rule, leaving state insurance regulators as the primary regulators of indexed annuities. Many opponents of the rule, who would presumably support the draft legislation, see the extra SEC regulatory layer as unnecessarily duplicative of the existing state insurance regulation. They may point out, for example, that the SEC has had authority over variable annuity products for many years, yet consumer complaints regarding these products continue to be heard. The SEC registration requirements which would be annulled by the legislation involve some cost. Due to the increasing cost for those offering indexed annuities, opponents of Rule 151A argue, some companies might choose to discontinue these products, or individual agents or brokers might choose to stop selling them. This could reduce the supply of what some see as an important retirement product.

⁶ U.S. Securities and Exchange Commission, "Indexed Annuities and Certain Other Insurance Contracts; Final Rule," 74 *Federal Register* 3164, January 16, 2009, also available at <http://www.sec.gov/rules/final/2009/33-8996.pdf>.

⁷ Full SEC discussion of costs can be found in their final rule at U.S. Securities and Exchange Commission, "Indexed Annuities and Certain Other Insurance Contracts; Final Rule," 74 *Federal Register* 3138-3176, January 16, 2009, also available at <http://www.sec.gov/rules/final/2009/33-8996.pdf>.

The SEC and supporters of Rule 151A, who would presumably oppose the legislation, do not see the additional regulation for the indexed annuity market as duplicative. Rather, they characterize Rule 151A as providing necessary protection for consumers. The SEC also argues that since indexed annuities expose consumers to investment risk, these annuities should be treated as securities products and consumers should have the same protections when they purchase indexed annuities as when they purchase securities. They agree that this regulation has some costs, and argue the costs are offset by consumer benefits such as enhanced disclosure and standardization of selling practices. The continued existence of abuses in variable annuities, despite both SEC and state regulation, may also be an argument for supporting additional oversight for indexed annuities, which share some similar characteristics.
